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EDWARD J. EMMONS, CLERK
U.S. BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA



Signed and Filed: April 29, 2019

Dennis Montali

DENNIS MONTALI
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

In re) Bankruptcy Case
YELLOW CAB COOPERATIVE, INC.,) No. 16-30063-DM
) Chapter 11
)
)
) Debtor.)
)
) RANDY SUGARMAN, Chapter 11 Trustee) Adv. Proc. No. 18-03075
for Yellow Cab Cooperative, Inc.,)
)
) Plaintiff,)
)
) vs.)
)
) DOUGLAS A. TAYLOR,)
)
) Defendant.)

MEMORANDUM DECISION REGARDING DEFENDANT'S MOTION TO DISMISS
ADVERSARY PROCEEDING

On March 8, 2019, this court held a hearing on the motion of defendant Douglas A. Taylor ("Taylor"), the former accountant for debtor Yellow Cab Cooperative, Inc. ("Debtor" or "YCC"), for dismissal of this action filed by Randy Sugarman, the chapter 11 trustee of YCC ("Trustee"). The court took the matter under submission. For the reasons set forth below, the court finds that the doctrine of *in pari delicto* (also known as "unclean hands")

1 bars the Trustee's action. Accordingly, the court will dismiss the
2 adversary proceeding, with leave to amend.

3 I. The Complaint

4 On October 31, 2018, Trustee filed an action in state court
5 against Taylor asserting three causes of action: (1) Professional
6 Negligence, (2) Accounting Malpractice, and (3) Conspiracy.¹ On
7 December 5, 2018, Taylor removed the action to this court [Dkt. 1].
8 On December 12, 2018, Taylor moved for dismissal of the action
9 [Dkt. 4]. Thereafter, Trustee filed his opposition [Dkt. 10] and
10 Taylor filed his reply [Dkt. 11].

11 Trustee alleges in paragraphs 17-22 of the complaint that YCC
12 made improper patronage distributions from 2012-2015, and that
13 Taylor calculated the amounts to be distributed. Moreover, the
14 complaint alleges that Taylor willfully or negligently categorized
15 multiple personal injury lawsuits as "reasonably possible"
16 liabilities (Dkt. 1, ¶¶ 27 - 33), even though the claims were
17 likely future liabilities (and at least one had been tried by a
18 jury that ruled in favor of the plaintiff), and that he did not
19 comply with Generally Accepted Accounting Principles. According to
20 Trustee, these errors (whether negligent or intentional)
21 facilitated the improper transfer of funds to owner-drivers and the
22 depletion of the company's assets.

23 In addition to alleging negligence and malpractice, Trustee
24 asserted that Taylor had conspired with Debtor and its officers and
25 directors to divest Debtor of "valuable and necessary assets to
26 allow improper distributions to YCC members and to hide money from
27 creditors and judgment creditors." Dkt. 1 at ¶ 16. Paragraph 16

28 ¹The preface to the complaint states that the action is for professional negligence, deepening the insolvency of YCC, and accounting and auditing malpractice.

1 summarizes Trustee's lawsuit and describes the purported misconduct
2 giving rise to it:

3 16. From at least 2007 until the Trustee was
4 appointed, YCC was under the control of its officers
5 and directors who were also YCC members and
6 medallion holders. There were no outside directors
7 of YCC. On information and belief, Taylor conspired
with YCC's officers and directors to divest YCC of
valuable and necessary assets to allow improper
distributions to YCC members and to hide money from
creditors and judgment creditors. Specifically,
8 Taylor worked with YCC management to help funnel YCC
assets to the unrelated entity, TPC, and its
subsidiaries, calculated and assisted YCC in making
9 economically irresponsible patronage distributions
to YCC members, and negligently failed to properly
10 account for judgments and liabilities of YCC so it
could properly preserve assets and reserve
11 sufficient capital to account for reasonably
12 probable liabilities of YCC. Taylor participated in
13 and assisted YCC's management to funnel money away
from YCC to line the members' pockets at the expense
14 of the financial health of YCC. This resulted in YCC
15 being undercapitalized, underinsured, without
sufficient reserves, and without the assets to meet
its obligations and liabilities, which ultimately
resulted in YCC's demise through bankruptcy and the
non-payment of claims and judgments against YCC.
16

17 *Id.* at ¶ 16 (emphasis added).

18 The complaint describes the two types of distributions made to
19 members (Profit Distributions and Patronage Distributions) and
20 alleges that YCC paid Patronage Distributions "without regard to
21 their reasonableness or the financial health of YCC." *Id.* at ¶¶
22 17-19. Trustee further alleges that Taylor provided YCC with an
23 annual calculation of the Patronage Distributions and "was fully
24 aware YCC made unlawful Patronage Distributions to non-voting
25 members not entitled to them, while technically insolvent." *Id.* at
26 ¶¶ 21-22.

27 Paragraphs 27-33 of the complaint focus on the inadequacies,
28 errors, and misstatements in Taylor's audit reports. While the

1 bulk of those allegations pertain to the facts giving rise to the
2 professional negligence claim (the first cause of action),
3 paragraph 33 is broader and appears to develop a deepening
4 insolvency theory: "Taylor conspired with YCC's officers and
5 directors to avoid financial prudence with YCC, which would have
6 shown YCC to be insolvent, so that the members could continue to
7 take money out of YCC to YCC's and its creditors' detriment." *Id.*

8 According to Trustee, Taylor's professional negligence,
9 accounting and auditing malpractice, and conspiracy with YCC's
10 officers and directors resulted in YCC's ultimate demise and non-
11 payment of claims and judgments against YCC." *Id.*; see also ¶¶ 22,
12 33, and 45-46 of the Complaint.²

13 **II. Taylor's Grounds for Dismissal**

14 Taylor asserted three grounds for dismissal of the Trustee's
15 claims: (1) the doctrine of *in pari delicto* (or unclean hands) bars
16 them; (2) any damages arising from the alleged conduct were not
17 caused by him, but by YCC's officers and directors, who have
18 already settled with the trustee; and (3) conspiracy is not an
19 independent tort under California law. As discussed in more detail
20 below, the court agrees with Taylor's first contention that the
21 doctrine of unclean hands bars Trustee's claims.

22 **A. The Unclean Hands Defense**

23 **1. The Defense Generally**

24 Section 3517 of the California Civil Code generally codifies

25

26 ²Interestingly, many of the allegations made by Trustee
27 against Taylor are almost identical to the claims he made against
28 YCC's officers and directors in *Sugarman v. Mellegard, et al.*, Case
No. CBC-18-563681 in the Superior Court of the State of California,
City of San Francisco. (The complaint in the Mellegard action is
attached as Exhibit A to the underlying motion to dismiss at Dkt.
4-2. See Part II(A) of the Reply Brief (Dkt. 11 at pages 4-7)).

1 the doctrine of *in pari delicto* or unclean hands: "No one can take
2 advantage of his own wrong." Case law is much more specific. As
3 noted in *In re Mortgage Fund '08 LLC*, 527 B.R. 351, 366 (N.D. Cal.
4 2015), "[t]he doctrine of *in pari delicto* dictates that when a
5 participant in illegal, fraudulent, or inequitable conduct seeks to
6 recover from another participant in that conduct, the parties are
7 deemed *in pari delicto*, and the law will aid neither, but rather,
8 will leave them where it finds them." *Id.*, citing *Case v. U.S. Bank. Nat. Assn.*, 127 Cal. App. 4th 1138, 1143 n. 1 (2005).

10 Both federal and state courts in California have applied the
11 *in pari delicto* defense to dismiss actions filed by bankruptcy
12 trustees against third parties who may have participated with a
13 debtor or a debtor's management in the concealment or dissipation
14 of the debtor's assets prior to the petition date. See, e.g.
15 *Mortg. Fund '08*, 527 B.R. at 366; *Uecker v. Zentil*, 244 Cal. App.
16 4th 789, 798 (2016) (determining that claims asserted by a
17 bankruptcy trustee against a former attorney for debtor limited
18 liability company were barred in part by the *in pari delicto*
19 doctrine); *Peregrine Funding, Inc. v. Sheppard Mullin Richter &*
20 *Hampton LLP*, 133 Cal. App. 4th 658, 679 (2005) (*in pari delicto*
21 doctrine barred bankruptcy trustee of a debtor investment company
22 from joining investors in an action for fraud against an attorney
23 for aiding the debtor in its purported fraud on investors).

24 **2. Governing Law from this District**

25 While application of the unclean hands defense generally
26 involves an examination of the relationship between parties to a
27 lawsuit and their relative culpability for the alleged misconduct,
28 the determination of the validity of such a defense in a bankruptcy

1 context is more difficult, where the plaintiff is generally a
2 trustee and a non-participant in the actions leading to the
3 lawsuit. That said, judges for the U.S. District Court for the
4 Northern District of California (the "District Court") have held
5 that bankruptcy trustees are subject to an unclean hands defense
6 arising from a debtor's pre-petition conduct vis-a-vis a defendant.

7 In *Mortg. Fund '08*, the District Court held that trustees are
8 subject to *in pari delicto* defenses that could have been asserted
9 against a debtor plaintiff. 527 B.R. at 367-68. There, the
10 trustee sued a line of credit lender, alleging claims for
11 fraudulent transfer and for aiding and abetting a breach of
12 fiduciary duty by the debtor. The lender asserted an *in pari*
13 *delicto* defense, and the trustee argued that the defense was
14 inapplicable, as she [the trustee] was not a wrongdoer and was not
15 involved in the acts giving rise to the defense. *Id.* The District
16 Court disagreed, holding that even though the trustee was not a
17 wrongdoer, the actions of the debtor's sole owner, member and
18 manager were imputed to the debtor and thus the trustee:

19
20 The Ninth Circuit has not addressed, in a published
opinion, the applicability of the *in pari delicto*
21 doctrine to claims brought by a liquidating trustee.
However, in an unpublished decision, the Ninth Circuit
22 affirmed a decision by Judge Chesney of this Court in
which she held that the *in pari delicto* defense could be
asserted against a bankruptcy trustee because "[w]here,
23 as here, a bankruptcy trustee files claims on behalf of
the bankruptcy estate, § 541(a)(1) ... provides that the
trustee's rights are no greater than the rights of the
debtor."

24
25 *Id.*, citing *In re Crown Vantage, Inc.*, No. 023836 MMC, 2003 WL
26 25257821, at *6 (N.D. Cal. Sept. 25, 2003), aff'd, 198 Fed. Appx.
27 597 (9th Cir. 2006) (affirming the "well-reasoned" orders).
28

1 In *Mortgage Fund*, the District Court also cited the
2 legislative history to section 541 in support of its conclusion
3 that bankruptcy trustees are subject to the *in pari delicto*
4 defense:

5 Though this paragraph [§ 541(a)(1)] will include
6 choses in action and claims by the debtor against
7 others, it is not intended to expand the debtor's
rights against others more than they exist at the
8 commencement of the case. For example, if the
9 debtor has a claim that is barred at the time of the
commencement of the case by the statute of
limitations, then the trustee would not be able to
pursue that claim, because he too would be barred.

10 *Mortg. Fund '08*, 527 B.R. at 367, quoting H.R. Rep. 95-595, at
11 367-68, reprinted in 1978 U.S.C.C.A.N. 5963, 6323 (emphasis
12 added). Relying on case law, legislative history and statutory
13 interpretation, the District Court held that the trustee's claims
14 were barred under the doctrine of *in pari delicto*.

15 In *Crown Vantage*, 2003 WL 25257821, a liquidating trustee
16 asserted claims against numerous defendants arising out of the
17 alleged fraudulent looting of a corporation. The District Court
18 held that the defendants could assert the *in pari delicto* defense
19 against claims brought by the trustee, even though the trustee was
20 not the actual person/entity that had acted in a manner to give
21 rise to that defense:

22 As explained in [*Sender v. Buchanan (In re* *Hedged-Investments Associates, Inc.*), 84 F.3d 1281,
23 1284-86 (10th Cir. 1996)], when a trustee asserts a
claim on behalf of a debtor, the trustee proceeds
under 11 U.S.C. § 541(a)(1), which defines the
property of the estate as "all legal or equitable
interests of the debtor *in property as of the*
commencement of the case." See *Sender*, 84 F.3d at
26 1285 (citing 11 U.S.C. § 541(a)(1)). *Sender*
concluded that § 541(a)(1) "establishes the
estate's rights as no stronger than they were when
actually held by the debtor," and thus *in pari*
delicto, or any other defense available as against
the debtor, can be asserted against the trustee.
See *id.*

1 *Id.* at *6-7.

2 Both trustees in *Crown Vantage and Mortgage Fund '08* argued
3 that the Ninth Circuit's decision in *Federal Deposit Ins. Corp. v.*
4 *O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995), precluded the
5 application of the *in pari delicto* defense. The District Court
6 disagreed. In *O'Melveny*, the Ninth Circuit, applying California
7 law, held that "defenses based on a party's unclean hands or
8 inequitable conduct do not generally apply against that party's
9 receiver." See *id.* at 19 (emphasis added). *O'Melveny* is
10 therefore distinguishable, as it involved a receiver, a party not
11 subject to the restrictions of section 541(a)(1). In contrast,
12 Trustee's powers are limited by section 541(a)(1), which provides
13 that a trustee's rights are no greater than the rights of a
14 debtor.³

15 **3. Trustee's Defenses to the Unclean Hands Doctrine**

16 Trustee asserts that an "adverse interest exception"
17 precludes application of the *in pari delicto* defense by
18 Defendant. The "adverse interest exception" provides that where
19 corporate agents act in a manner adverse to the interests of the
20 corporation, the actions of the agents are not imputed to the

22 ³ Even in actions predating section 541, the Ninth Circuit
23 stated, "It is elemental that the trustee stands in the shoes of
24 the bankrupt ... and can assert no greater rights against the
25 [defendant] than could have been asserted by the bankrupt in the
26 absence of bankruptcy proceedings." See *Schultz v. England*, 106
27 F.2d 764, 768 (9th Cir. 1939) (holding resolution of trustee's
28 claim to equipment in building leased by landlord to debtor was
dependent on whether debtor had right to possess equipment as
against landlord); see also *Pellerin v. Stuhley (In re Destro)*,
675 F.2d 1037, 1040 (9th Cir. 1982) (holding that bankruptcy
trustee "succeeds only to such rights as the bankrupt possessed;
and the trustee is subject to all claims and defenses which might
have been asserted against the bankrupt but for the filing of the
petition"). *Crown Vantage*, 2003 WL 25257821, at *6-7.

1 corporation. Trustee contends that if the actions of the board
2 members and officers cannot be imputed to Debtor, they likewise
3 cannot be imputed to Trustee.

4 The "adverse interest exception," however, is subject to
5 its own exception, the "sole actor" exception. *In re Mortgage*
6 *Fund '08 LLC*, 527 B.R. at 351, citing *Crown Vantage, Inc.*, 2003
7 WL 25257821, at *7. The "sole actor" exception provides that a
8 defrauded entity cannot escape the imputation of knowledge under
9 the *in pari delicto* doctrine when the defrauded entity and the
10 alleged bad actors are one and the same. *Id.*
11

12 Here, Trustee alleges that "YCC was under the control of
13 its officers and directors who were also YCC members and
14 medallion holders." *Complaint*, Dkt. 1 at ¶ 16. "On
15 information and belief, Taylor conspired with YCC's officers and
16 directors to divest YCC of valuable and necessary assets to
17 allow improper distributions to YCC members and to hide money
18 from creditors and judgment creditors." *Id.* "Taylor
19 participated in and assisted YCC's management to funnel money
20 away from YCC to line the members' pockets at the expense of the
21 financial health of YCC." *Id.* Given these allegations,
22 particularly the allegation that the "bad actors" (the board and
23 members) controlled the Debtor, the purportedly defrauded entity
24 (Debtor) and the same and thus subject to the "sole actor"
25 exception to the "adverse interest exception" to the doctrine of
26 *in pari delicto*. In other words and as a consequence, Trustee
27 cannot prevail on the "adverse interest exception" in the
28 doctrine of *in pari delicto*. The *in pari delicto* defense

1 therefore bars the claims of Trustee against Taylor.

B. Taylor's Other Defenses

As noted previously, Taylor asserts that any damages arising from the alleged conduct were not caused by him, but by YCC's officers and directors, who have already settled with the Trustee. Causation is a factual issue, and but for the claims being barred under the *in pari delicto* doctrine, Trustee has alleged sufficient facts to survive a motion to dismiss based on lack of causation. That said, Trustee may have an independent claim for malpractice against Taylor not arising from and independent of the alleged fraud of the debtor and its members. The court will therefore dismiss all claims in the Complaint, with leave to amend the accounting malpractice claim.

15 III. Conclusion

16 For the reasons set forth above, the court will grant
17 Taylor's motion to dismiss with leave to amend the accounting
18 malpractice claim. Trustee shall file the amended complaint no
19 later than May 31, 2019; if the amended complaint is timely filed,
20 the adversary proceeding status conference will be held on June 28,
21 2019, at 1:30 p.m.

22 Counsel for Taylor shall upload an order granting the motion
23 with leave to amend "for the reasons set forth in the Memorandum
24 Decision entered on [date].” Counsel for Taylor shall also comply
25 with B.L.R. 9021-1(c) and file (on the docket, separate from the
26 order) a certificate of service reflecting such compliance.

END OF MEMORANDUM DECISION